
Problem Financial Institution Resolution

**USAID Financial Sector Training
Arlington, VA
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Topics for Discussion



Financial Sector: Definition and Importance

**Financial Institution Resolution: Key Issues and System
Components**

Resolution Strategies

Asset Management and Recovery

Financial Sector: Definition and Importance

Basic Premise

Unhealthy financial institutions impede efforts to achieve sustainable economic growth and prevent other financial sector reforms from fully achieving intended results

Defining Financial Institutions and Problem Resolution



Financial Institutions (FIs) include:

- Banks, insurance companies, investment banks, pension funds and other financial intermediaries
- In most economies, banks are the most important to economic development

Problems involve:

- Serious liquidity, solvency or operational deficiencies that impede FIs ability to serve the economy

Resolution Is Important



Financial Sector problems impede economic development

- Restricted intermediation and credit function
- Need to recycle non-productive assets to best use
- Need to remove non-viable assets from banking system

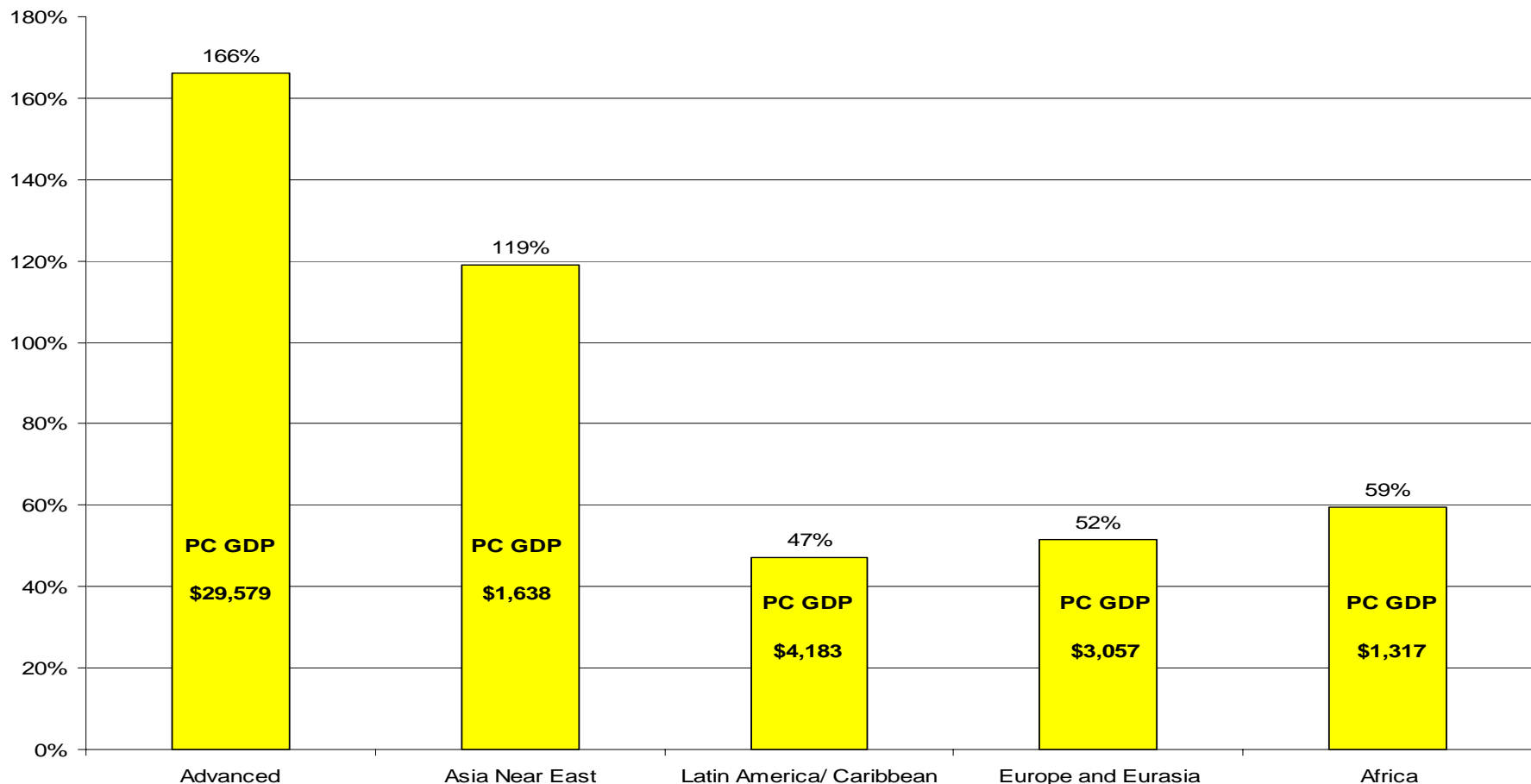
Problem FIs impede efforts to strengthen financial sector

- Oppose safety and soundness regulations
- Oppose improvements in bank bankruptcy legislation
- Oppose market competition

Banking Assets to GDP per Capita USAID Regions

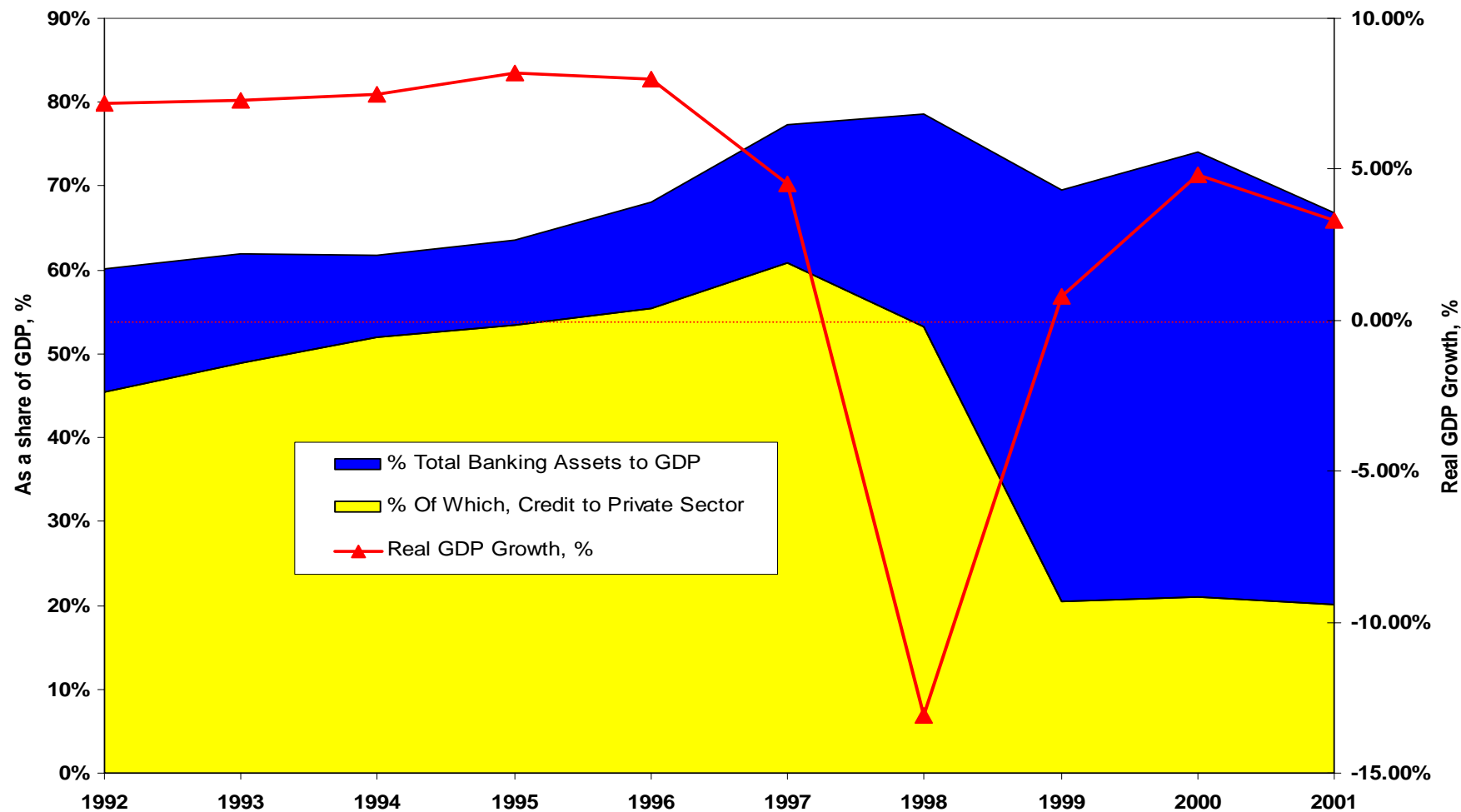


Banking Assets as % of GDP
Weighted Average



Banking Assets and Economic Growth - Indonesia

Banking Assets and Economic Growth in Indonesia, 1992-2001



Source: IMF International Financial Statistics On-line Database.

Characteristics of an Anemic or Distressed Financial Sector



■ Undercapitalized Financial Institutions

- Lack of Investors
- Inability to lend to viable businesses

■ Significant Levels of Non-Performing Loans (NPLS)

- Disrupted or non-existent credit functions

■ High Funding Costs

- Lack of depositor confidence
- Requirements of blanket government guarantee

RESULT: Development and growth of economy is impaired

Robust Growth in a Market Economy Requires a Healthy Financial Sector



Resolution requires developing and implementing a systematic process to rehabilitate, restructure, sell or liquidate problem FIs

- Resolution strategies should seek to minimize burden to government and community served but;
- Having similar goals does not mean having the same resolution strategy - One size does not fit all!
- A healthy financial sector requires both preventing and curing problems:
 - **Supervision and Regulation**
 - **Legal and Cultural Environment/ Climate**
 - **Confidence**
 - **Creditors' Rights**
 - **Competition and Discipline**

Cure and Climate



CURE

FI Resolution

Asset Management and Recovery

- Assessment/ Diagnostic
- Strategy Design
 - Rehabilitation
 - Liquidation
 - Sale
- Implementation
- Identification/Stratification
- Prioritization/Valuation
- Market Assessment
- Asset Recovery Strategies
- Implementation

CLIMATE

Deposit Insurance

- Strategic Design
- Coverage and Funding
- Governance and Management
- Organization and Operations
- Functional Area Development

Public Education

MIS/IT

Accounting & Reporting

Oversight

SUPPORT FUNCTIONS

USAID Resolution Engagements



Project	Bank Rehabilitation & Privatization	Asset Management & Recovery	Problem Loan Workout	Deposit Insurance
Bulgaria				
Croatia				
Poland				
Slovakia				
Bosnia & Herzegovina				
Romania				
Yugoslavia - Montenegro and Serbia				
Armenia				
Ukraine				
Ecuador				
Kazakhstan				
Indonesia				

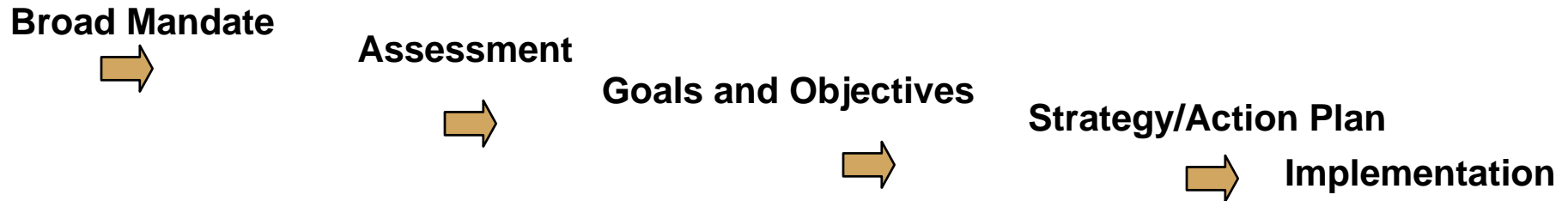
Deposit Insurance



- **Most governments are implementing some level of explicit insurance coverage**
- **Some countries appoint the Insurer as receiver or conservator of the failed institution**
- **Deposit insurance prompts many policy issues**
 - ✓ Membership
 - ✓ Coverage and Depositor Priority
 - ✓ Cross Border Issues
 - ✓ Structure and Organization
 - ✓ Powers
 - ✓ Funding
 - ✓ Moral Hazard Issues
 - ✓ Public Awareness and Outreach

Basic Resolution Strategies

Curative Resolution Process



Curative Process Components

Financial Institution Resolution

- Restructuring, Privatization, and Bank Sales
- Liquidation and Bankruptcy Administration
- Problem Loan Workout and Restructuring
- Legal and Regulatory

Asset Management & Recovery

- Debtor Restructuring
- Asset Management
- Asset Valuation
- Asset Recovery
- Asset Enhancement Options

Public Education

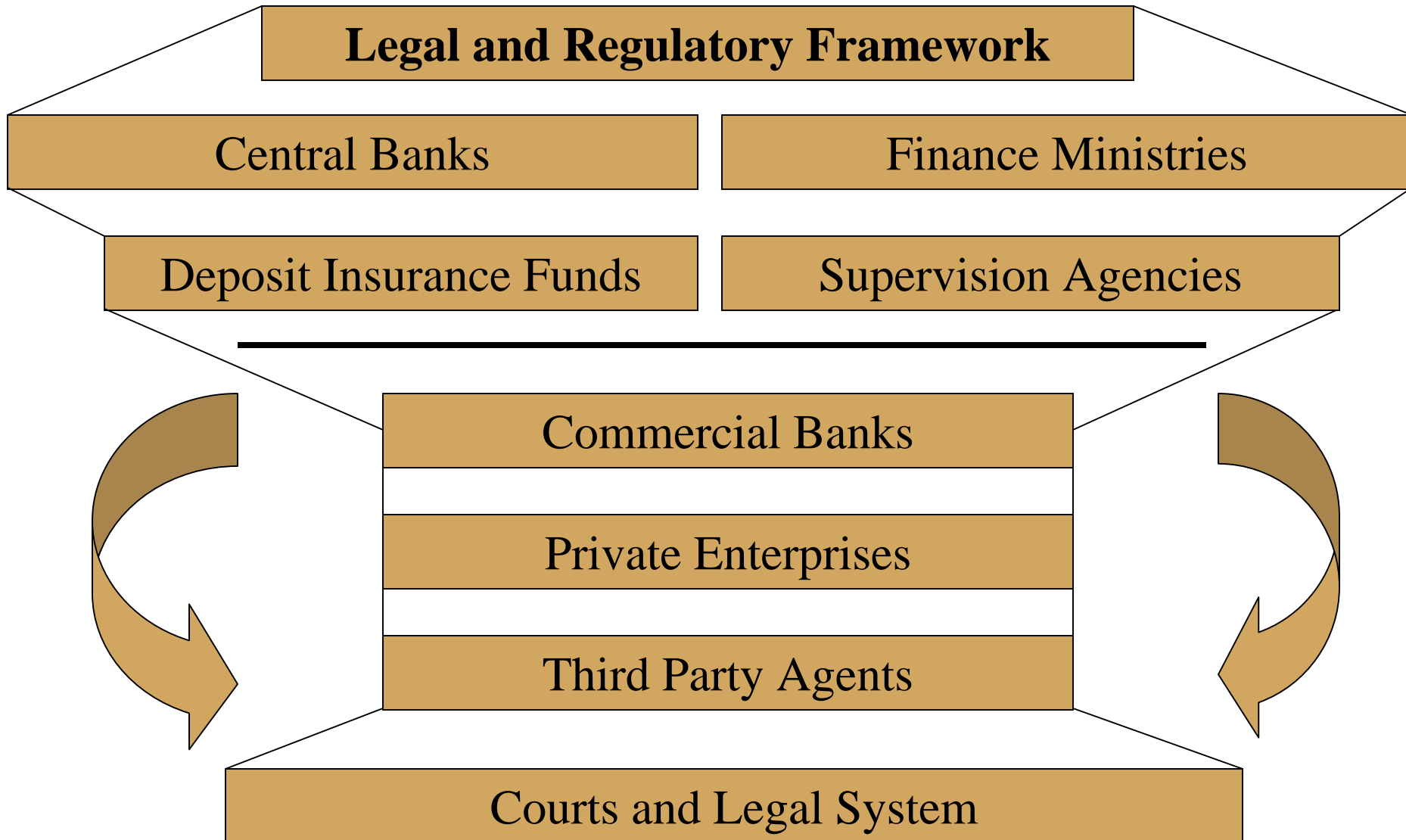
MIS/IT

Corporate Governance

Strategy-Implementation-Oversight

SUPPORT FUNCTIONS

Key Players



Common Approaches to FI Resolution



- Regulatory Forbearance
- Open Bank Assistance
- Assisted Merger
- Purchase and Assumption Transaction
- Bridge Bank or Conservatorship
- Liquidation

Regulatory Forbearance



- Government waives or does not enforce prudential banking standards
 - Objective is to provide a troubled bank time to strengthen itself
- Success requires controls and monitoring
 - With performance benchmarks and consequences
- Change in management? Can existing management work itself out of trouble if they got bank into trouble?
- Usually unsuccessful and results in higher costs

Open Bank Assistance (OBA)



- **Government provides financial assistance - loans or deposits, purchase assets, injects capital or assume liabilities**
- **OBA has attractive potential benefits**
 - Less disruptive to the community
 - Preserves franchise value
 - Reduces losses on performing loans
- **Potential disadvantages**
 - Fairness Issues – public and competitors
 - Moral Hazards – increased costs
 - Management ability
 - Implementation problems – shareholder and legal
- **Requires Key Policy Decisions**
 - Who qualifies, who provides, what type, how much, and when to provide

Assisted Merger



- **Government assists the merger of two banks**
 - Can result in bigger problems
- **Best when healthy banks compete to take over a weaker bank**
 - Is provided sufficient financial assistance
 - Has the financial and operational capacity to absorb weaker bank

Bridge Bank/Conservatorship



- Provides time to structure a final solution
- Continues to provide essential banking services
- Existing shareholders and other subordinated claims are left behind as claims against the failed bank's estate

Purchase & Assumption (P&A)



- A closed bank merger
- A healthy bank agrees to assume the deposit and other liabilities of a failed bank in return for its good assets and cash or notes from the government
- Most used solution in US

Liquidation



- For institutions that are not viable and that have limited franchise value
- Usually entails depositor (or deposit insurance fund) loss
- Can be performed on an entity-by-entity basis or on a systemic basis
- Usually involves selling assets at the market clearing price – which can be substantially less than nominal value
- Requires infrastructure/agency to manage process
- Requires prompt loss recognition

Asset Management and Recovery

Non Performing Loans (NPLs)



Range from

- Rapidly selling NPLs in competitive marketing process to
Investing time and money to restructure NPLs and debtors and
then holding or selling
- Rapid sales approach is faster with easier to measure results but
prices tend to be lower
- Restructuring is slower but net proceeds could be higher – but
results are difficult to evaluate

NPL Strategy Considerations



- Type of Problem Loans
- Size and Complexity of Problems
- Political Environment
- Legal and Regulatory Framework
- Availability of Funding
- Availability of Experienced Personnel
- Quality of Information

Tradeoffs in the Resolution Approach



- **Support for bank rehabilitation can result in overvalued prices for NPLs/NPAs**
- **A desire to minimize budget Impact can result in costly delays in action**
- **A desire to maximize NPL/NPA recoveries can result in over committing resources to enhance values through restructuring**

Implementing Resolution Programs Involves Critical Steps



Assess Legal and Regulatory Environment

- Banking laws
- Regulatory authority
- Bank bankruptcy provisions
- Bankruptcy and Collateral laws

Develop documents and manuals to implement resolution strategies

Selected Resolution Steps



- Creation of Asset Management Company
 - Criteria and process for carve-out of distressed assets
 - Documentation for assets transfers
 - Interim management of transferred assets
- Develop Sales Agreement
- Develop Due Diligence and Valuation Process
- Develop Marketing – International and Domestic Campaign
- Identify and Stratify Assets for Recovery
- Develop Sales Agreement and Closing Documents
- Quantify Eligible Deposits and Identify Priority of Depositors
- Develop Auction and Closing Procedures
- Develop and Conduct Marketing Campaign

Legal and Regulatory Framework



Legal:

Law must provide for speedy and fair resolution of claims against assets – bankruptcy, special bank or insurance company insolvency law, foreclosure and other commercial laws.

Regulatory:

Resolution Agency must have the power to perform its function and protection for exercise of its discretion.

Judicial:

Court system must allow for protection of rights in an expeditious and predictable fashion. Title must be clearly ascertainable and enforceable.

Corporate Governance, Oversight, and Transparency



- Stakeholders must have the power to obtain information and to hold bad actors responsible.
- Corporate governance laws must provide a remedy for stakeholders (shareholders, creditors, etc.) in the event of misfeasance or malfeasance by controlling persons at the financial institution.
- Criminal code must make financial crimes (theft, fraudulent loans, diversion of company resources) feasible to prosecute. Remedies should lie both with the defrauded entity and the shareholders, creditors and other stakeholders of the defrauded entity.
- Regulator must have the power to obtain data and to enforce compliance with regulation.

A Few Final Thoughts



- **Resolution Goals and Policies Must Be Clear**
- **Asset Values And Recovery Expectations Must Be Realistic**
- **Process Must Be Transaction Oriented with Proper Incentives and Benchmarks**
- **Information Needs Must Be Recognized**
- **Government Buy-in and Support**

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